

Message Text

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P 132236Z JUL 78
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC PRIORITY 8044
INFO AMCONSUL MONTREAL
ALL OTHER CONGENS IN CANADA POUCH

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DEPT. PASS TREASURY FOR TEMPLEMAN

E.O. 11652:N/A
TAGS: ECON, EFIN, CA
SUBJECT: ECONOMIC DEVELOPMENTS: TWO WEEKS ENDING JULY 7.

1. SUMMARY: FINANCE MINISTER CHRETIEN HAS SAID THE SALES TAX REDUCTION WILL NOT BE EXTENDED BEYOND OCTOBER, BUT NO FINAL DECISION ABOUT THE TAX HAS YET BEEN MADE. A NUMBER OF STUDIES HAVE CALLED FOR LOWERING PROTECTION FOR CANADIAN INDUSTRIES, ESPECIALLY TEXTILES. CONSUMER PRICES SURGED IN JUNE TO A LEVEL 9.2 PERCENT HIGHER THAN A YEAR AGO, BUT NON-FOOD PRICES DECLINED. UNEMPLOYMENT REMAINS STEADY AT 8.6 PERCENT. INTEREST RATES IN CANADA HAVE NOT FOLLOWED U.S. RATES UPWARD, LOWERING RATE DIFFERENTIAL AND ADDING DOWNWARD PRESSURE TO THE CANADIAN DOLLAR. END SUMMARY.

2. POLICY DEVELOPMENTS. SALES TAX: FINANCE MINISTER CHRETIEN TOLD A FEDERAL/PROVINCIAL MEETING JULY 7 THAT THE PROVINCIAL SALES TAX REDUCTIONS FINANCED BY THE FEDERAL

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GOVERNMENT WILL NOT BE EXTENDED BEYOND THE SCHEDULED OCTOBER TERMINATION DATE. MINISTERS FROM THE ATLANTIC PROVINCES (WHICH DO NOT SHARE IN THE FINANCING) AND MANITOBA EXPRESSED INTEREST IN EXTENDING THE TAX CUTS BECAUSE OF WEAK ECONOMIC CONDITIONS. SASKATCHEWAN INDICATED A DESIRE FOR SOME KIND OF TAX RELIEF PROGRAM AFTER OCTOBER.

COMMENT: IT IS UNLIKELY THAT ANY INTENTION TO EXTEND THE SALES TAX CUT, SHOULD IT EXIST, WOULD BE SIGNALLED BY THE FEDERAL GOVERNMENT UNTIL THE LAST MOMENT. FINANCE DEPT. OFFICIALS TOLD US IN FACT NO FINAL DECISION HAS BEEN MADE RE. EXTENSION OF TAX REDUCTION. GIVEN 8.6 PERCENT UNEMPLOYMENT AND 9.2 PERCENT INFLATION (SEE BELOW), PRESSURES THIS FALL WILL NO DOUBT EXIST FOR SOME CONTINUATION OF THIS OR EQUIVALENT RELIEF.

3. BANK ACT: AN EXECUTIVE OF CITICORP CANADA HAS CRITICIZED PROPOSED CHANGES IN THE BANK ACT AS BEING TOO RESTRICTIVE ON FOREIGN BANKS. AT MEETING OF THE CONFERENCE BOARD IN TORONTO JUNE 28, HE POINTED OUT THAT WHILE THE PROPOSED CHANGE LIMITS THE COLLECTIVE ASSETS OF FOREIGN BANKS TO 15 PERCENT OF "COMMERCIAL LENDING", SUCH LENDING IS DEFINED IN SUCH A WAY AS TO EXCLUDE MANY CATEGORIES OF ASSETS SUCH AS MORTGAGES AND LEASES, SO THAT IN FACT FOREIGN BANKS IN THE AGGREGATE WOULD BE LIMITED TO ASSETS OF ABOUT DOLS 7 BILLION OR LESS, LESS THAN FIVE PERCENT OF THE TOTAL ASSETS OF CANADIAN CHARTERED BANKS. IN CONTRAST, HE SAID ASSETS OF CANADIAN CHARTERED BANKS IN NEW YORK STATE ALONE WERE ALMOST DOLS 9 BILLION AT THE END OF 1977.

4. HE SUGGESTED THAT THE PROPOSED BANK ACT CHANGES WOULD NOT GO FAR IN ACHIEVING THEIR STATED GOAL OF INCREASING COMPETITION IN THE HIGHLY CONCENTRATED CANADIAN BANKING LIMITED OFFICIAL USE

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SYSTEM, WHERE OUT OF ELEVEN EXISTING CHARTERED BANKS, FIVE HAVE ASSETS BETWEEN 19 AND 35 BILLION AND CONTROL 90 PERCENT OF MARKET. HE SAID LIMITATIONS ON FOREIGN BANKS WOULD MEAN THEY WOULD END UP SERVING PRIMARILY LARGE CORPORATIONS, WHO ARE ALREADY WELL-SERVED, AND WOULD DO LITTLE TO INCREASE SERVICES TO MEDIUM AND SMALL SIZED FIRMS WHERE GREATER COMPETITION IS NEEDED.

5. INDUSTRIAL STRATEGY. THE DOMESTIC DEBATE OVER PROTECTIONISM HIGHLIGHTED BY THREE RECENT STUDIES.

A. THE ECONOMIC COUNCIL OF CANADA (ECC) PUBLISHED REPORT, "FOR A COMMON FUTURE," CALLING FOR FREER TRADE WITH DEVELOPING COUNTRIES PLUS A MAJOR ADJUSTMENT PROGRAM OVER SEVERAL YEARS TO HELP CREATE ALTERNATE EMPLOYMENT FOR THOSE NOW WORKING IN HIGHLY PROTECTED DOMESTIC SECTORS SUCH AS TEXTILES. (SEE OTTAWA A-170.)

B. THE C.D. HOWE RESEARCH INSTITUTE PUBLISHED A STUDY ON THE QUEBEC TEXTILE INDUSTRY, URGING IN A SIMILAR VEIN THAT IT BE PHASED OUT GRADUALLY AND RESOURCES BE BETTER ALLOCATED INTO OTHER SECTORS.

C. A FEDERAL STUDY, AS YET UNPUBLISHED, DONE BY THE TASK FORCE EXAMINING AN INDUSTRIAL STRATEGY, REPORTEDLY ACKNOWLEDGES THAT LESS PROTECTION AND MORE ADJUSTMENT

IS DESIRABLE, BUT PUTS GREATER EMPHASIS ON THE SOCIAL
(AND POLITICAL) COSTS OF ADJUSTMENT, ESPECIALLY FOR
IMMOBILE LABOR IN SMALL FRANCOPHONE COMMUNITIES OF QUEBEC.
IT REPORTEDLY RECOMMENDS CONTINUED, IF NOT PERMANENT,
PROTECTION FOR A NUMBER OF INDUSTRIES. ALL THE STUDIES
ACKNOWLEDGE THAT STRUCTURAL ADJUSTMENT WILL BE PAINFUL,
TAKE CONSIDERABLE TIME, AND IMPLICITLY ACKNOWLEDGE THAT
WITH CURRENT HIGH RATES OF UNEMPLOYMENT FEW MAJOR CHANGES
CAN BE EXPECTED SOON.

6. ECONOMIC INDICATORS.

--CONSUMER PRICES CONTINUE TO RISE RAPIDLY DUE TO FOOD,

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DESPITE GOOD PERFORMANCE OF NON-FOOD PRICES.

--THE CPI ROSE 0.6 PERCENT (SA) IN JUNE, DOWN FROM A 1.2
PERCENT RISE IN MAY. TWELVE MONTH INCREASE TO JUNE OF
CPI WAS 9.2 PERCENT, UP FROM 9.0 PERCENT IN SAME PERIOD
TO MAY. MOST OF INCREASE CAME FROM HIGHER FOOD PRICES,
ESPECIALLY BEEF. HOWEVER, NON-FOOD PRICES IN LAST THREE
MONTHS HAVE RISEN ONLY 2.5 PERCENT (SAAR). (SEE OTTAWA
SEPTEL).

--THE INDEX OF INDUSTRIAL SELLING PRICES WAS UP 0.4 PERCENT
IN MAY TO 186.3. IN THE PRECEDING TWELVE MONTHS IN ISP
INDEX ROSE 7.3 PERCENT.

--THE UNEMPLOYMENT RATE (SA) WAS 8.6 PERCENT IN JUNE, UNCHANGED FROM MAY. UNADJUSTED UNEMPLOYMENT DROPPED. (SEE OTTAWA 3477).

--HOUSING STARTS IN JUNE WERE AT AN ANNUAL RATE OF 187,000, DOWN 5.8 PERCENT FROM MAY. STARTS IN THE SECOND QUARTER WERE AT AN ESTIMATED ANNUAL RATE OF 197,000, DOWN LIMITED OFFICIAL USE

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35 PERCENT FROM THE FIRST QUARTER, WHICH WAS INFLUENCED BY TEMPORARY TAX INCENTIVES. HOUSING, LIKE MOST PRIVATE INVESTMENT, IS EXPECTED TO CONTINUE WEAK DURING THE REST OF THE YEAR.

--MERCHANDISE TRADE BALANCE REGISTERED A CDOLS 343 MILLION SURPLUS IN MAY, UP FROM THE REVISED CDOLS 124 MILLION SURPLUS IN APRIL. THE TRADE SURPLUS FOR THE FIRST FIVE MONTHS HAS RUN AT AN ANNUAL RATE OF CDOLS 4.4 BILLION. FINANCE MINISTER CHRETIEN RECENT REPEATED PREDICTIONS THAT CANADA WILL HAVE A TRADE SURPLUS OF CDOLS 5 BILLION THIS YEAR. WHILE BALANCE WILL CONTINUE TO BENEFIT FROM PAST DOLLAR DEPRECIATION, WE SEE SOME TAPERING OFF OF SURPLUS LATER THIS YEAR RATHER THAN FURTHER IMPROVEMENT AND ESTIMATE SURPLUS AT JUST OVER CDOLS 4 BILLION.

7. FOREIGN BORROWING.

A. THE DEPARTMENT OF FINANCE ESTIMATES THAT GROSS FOREIGN BORROWING IN JUNE, NOT COUNTING GOC TRANSACTIONS, WAS CDOLS 575 MILLION, AND TOTAL BORROWING FOR THE FIRST HALF OF THE YEAR WAS JUST OVER CDOLS 4 BILLION. WOOD GUNDY LTD., ESTIMATES THAT INTEREST AND SINKING FUND PAYMENTS ABROAD IN JUNE WERE ABOUT 400 MILLION. WOOD GUNDY ALSO ESTIMATES THAT BORROWING BY CANADIAN ENTITIES IN OTHER THAN CANADIAN FUNDS, INCLUDING THE GOC 750 MILLION BOND ISSUE, WAS NEARLY DOLS 4.9 BILLION IN THE FIRST HALF OF THIS YEAR.

B. FOREIGN BORROWING ANNOUNCED SO FAR FOR JULY IS ABOUT DOLS 250 MILLION. THIS INCLUDES:

--A U.S. DOLS 100 MILLION PUBLIC ISSUE IN NEW YORK BY LIMITED OFFICIAL USE

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HYDRO QUEBEC (HQ) OF 30 YEAR DEBENTURES. THIS WILL BE THE FIRST PUBLIC OFFERING IN THE U.S. BY HYDRO QUEBEC

SINCE JUST PRIOR TO THE PARTI QUEBECOIS ELECTION VICTORY IN NOVEMBER 1976, ALTHOUGH HQ DID MAKE A 200 MILLION PRIVATE PLACEMENT IN THE U.S. LAST FALL. THE MODEST SIZE (FOR HQ) OF THIS ISSUE INDICATES THE FIRM AND ITS UNDERWRITERS ARE APPROACHING THE U.S. PUBLIC MARKET WITH SOME CAUTION. THE ISSUE WILL BE PRICED JULY 17. IT IS EXPECTED TO YIELD JUST OVER 10 PERCENT, AND ABOUT 75 BASIS POINTS MORE THAN AN ISSUE OF ONTARIO HYDRO WITH A SIMILAR MATURITY.

--THE CANADIAN DEVELOPMENT CORPORATION WILL MAKE A PRIVATE PLACEMENT OF 250 MILLION SWISS FRANCS (ABOUT CDOLS 150 MILLION). THE SEVEN YEAR NOTES WILL BEAR INTEREST OF ABOUT 4.37 PERCENT.

8. CANADIAN INTEREST RATES HAVE NOT RESPONDED COMMENSURATELY WITH RECENT RATE INCREASES IN THE U.S., AND INTEREST RATE DIFFERENTIALS IN FAVOR OF CANADA HAVE NARROWED ACCORDINGLY. THE YIELD ON THIRTY DAY CANADIAN COMMERCIAL PAPER HAS INCREASED TEN BASIS POINTS SINCE THE END OF APRIL TO 8.45 PERCENT ON JULY 6, BUT THE DIFFERENTIAL WITH EQUIVALENT U.S. COMMERCIAL PAPER HAS DROPPED DRAMATICALLY FROM 149 TO 67 BASIS POINTS IN THE SAME PERIOD. THE YIELD ON BONDS HAS CHANGED HARDLY AT ALL IN THE SAME PERIOD, WHILE THE DIFFERENTIAL WITH SIMILAR U.S. BONDS HAS DROPPED ABOUT 25 BASIS POINTS. THE INTEREST DIFFERENTIAL ON 90 DAY TREASURY BILLS DROPPED OVER 50 BASIS POINTS, FROM 177 TO 125, ALTHOUGH THE DIFFERENTIAL ON 30 DAY TREASURY BILLS HAS HELD STEADY AT ABOUT 160 BASIS POINTS AFTER A BRIEF DROP AT THE END OF JUNE.

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9. ANALYSTS POINT TO TECHNICAL FACTORS FOR THE LACK OF INTEREST RATE RESPONSE SUCH AS LOW DEALER INVENTORIES, STRONG CASH POSITIONS BY INSTITUTIONAL INVESTORS, AND A RELATIVELY SMALL NUMBER OF NEW DOMESTIC BOND ISSUES. IN ADDITION, THE BANK OF CANADA HAS NOT MOVED SIGNIFICANTLY TO TIGHTEN THE BANKING SYSTEM, PROBABLY OUT OF CONCERN FOR WEAK DOMESTIC ECONOMIC CONDITIONS, WHILE INTERVENTION BY THE BANK HAS REMAINED ACTIVE AS SHOWN BY THE USE OVER U.S. DOLS 400 MILLION IN U.S. DOLLAR RESERVES DURING JUNE.

10. THE CANADIAN DOLLAR HAS REMAINED UNDER MODEST DOWNWARD PRESSURE, AVERAGING 89.16 U.S. CENTS IN JUNE, DOWN FROM THE 89.42 AVERAGE IN MAY. IN THE WEEK ENDING JULY 7 THE RATE AVERAGED 89.05, UP FROM 88.90 FOR THE WEEK ENDING JUNE 30. WITH EXPECTED FOREIGN BORROWING LIGHT IN SUMMER MONTHS AND A PROBABLE TAPERING OFF OF INCREASES IN THE TRADE SURPLUS, THE SHORT TERM OUTLOOK FOR THE CANADIAN DOLLAR IS FOR LITTLE IMPROVEMENT AND POSSIBLY SOME SLIGHT FURTHER DOWNWARD PRESSURE.
ENDERS

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